IN THE

United States Circuit Court of Appeals

for the Ninth Circuit

COLUMBIA DIGGER COMPANY,
a Corporation,
Plaintiff in Error,

vs.

M. R. SPARKS and C. A. BLUROCK,
Defendants in Error.

BRIEF OF DEFENDANTS IN ERROR

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VANCOUVER, WASHINGTON
ATTORNEYS FOR DEFENDANTS IN ERROR

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STATEMENT.

This action was commenced by the plaintiff to recover the sum of $6189.88 for crushed rock which plaintiff alleges was furnished to contractors engaged in a public improvement of the City of Vancouver, Washington. The defendants were sureties under a bond given in pursuance of the provisions of Chapter 6, Title VIII, Remington & Ballinger's Annotated Code and Statutes of the State of Washington.

The improvement is known in the record as B Street in the City of Vancouver, Washington, and the material which plaintiff seeks to recover for was crushed rock which went into the improvement of the street. Before the contract was completed the contractors abandoned their contract and were declared bankrupts and the sureties completed the improvement and have settled the claims and demands that were legally chargeable against the improvement and for which they were liable under their bond.

It is contended by plaintiff that the sureties are liable for plaintiff's claim. This claim of plaintiff is based upon the right of the plaintiff to recover under the statutory bond mentioned above and does not grow out of any direct contractural relations between the plaintiff and these defendants.

It was alleged in the answer filed by these defendants that an agreement was entered into between the plaintiff and the principal contractors that the money received from time to time upon the estimates of the City Engineer was to be applied on the general indebtedness of Rector & Daly which was unsecured and that the plaintiff would look to the sureties for the material furnished for the improvement of B street, and that such agreement was without the knowledge and consent of the sureties and that payments were made by the City based upon the engineer's estimates to the contractors from time to

time, and that the contractors paid the money so received by them from the City to the plaintiff, and that the sum so received was in excess of the material furnished by the plaintiff and which was used in the improvement of the street.

These allegations were denied by the plaintiff in a reply filed by it and the principal issues raised by the pleadings were, first, the nature of the understanding and agreement had between Rector and Daly and the plaintiff as to the manner of payment for the material which went on this street; second, whether the City had made payments to the contractors and whether the contractors had, in turn, made payments from the money which was received from this improvement to the plaintiff; third, the manner in which payments received by plaintiff were applied by it and whether it had received sufficient sums which were derived from this improvement to liquidate and pay for the materials which went into this improvement.

ARGUMENT.

On pages 29 and 30 of the transcript of record M. A. Hackett, called as a witness for the plaintiff, testifies that before any crushed rock was furnished for this improvement that he came to Vancouver to find out when he could make deliveries of the rock and when he would

get his money for the crushed rock, and he states that Mr. Rector told him that he "could not pay in cash for the crushed rock, but as soon as he got his money off of B street, why, he would pay for the crushed rock, and that he would have to ask us to wait for the money until he did get his money from B street, and we asked him what surety he would have if we waited for our money, and he said that he had a bond to the City to pay for all labor and material, a good bond, he mentioned who was on the bond, Mr. Blurock and a man named Sparks, I think, and so under those conditions we thought we were perfectly safe in furnishing him the rock and waiting until he got his money off of B street, so we began to make deliveries as soon as we could."

Again, on page 33, the same witness on cross-examination says, "I guess that is right, but we were not to get any pay for rock on East B street until he got his money."

Again on page 41, the same witness on cross-examination says, "No sir, I would have delivered the rock whether he would have given me the check, or not; I was willing to furnish it until he got his money to pay me."

On page 48 the same witness, "Because we agreed to wait for him upon the rock, until he got his money."

On page 86 A. B. Rector, a witness for plaintiff, on

cross-examination admitted that at a former trial he testified as follows:

"Q. Did you have an arrangement with the Columbia Digger Company that you could do that and let the crushed rock account stand because you had a bond to protect you?

A. I think we probably did."

And again on page 87 the same witness:

"Q. When did you make this arrangement with the Columbia Digger Company, that the cash should go on the sand and gravel and the bondsmen stand for the crushed rock?

A. May or June, 1911.

Q. At that time did you tell Sparks and Blurock?

A. I did not."

Again on page 88 this same witness:

"Q. What arrangement did you have with the Columbia Digger Company with reference to credits of all money you sent them, where and how it should be credited?

A. All the money I should pay for sand and gravel so I would get my discount, that was the arrangement.

Q. That was all the arrangement?

A. All money paid should be applied on sand and

gravel so as to keep up our discount, any money to be paid there should be applied on sand and gravel.

Q. Any money should be applied on sand and gravel so as to preserve your discount?

A. So as to preserve.

Q. And your crushed rock should run?

A. Could run.

Q. And that was done?

A. Yes.

Q. And that arrangement was not called to the attention of the bondsmen?

A. I do not think so, in fact I know it was not."

This testimony quoted was brought out on cross-examination of this witness as having been testified to at a former trial, and he admitted that he so testified.

The record discloses that the contract which Rector & Daly had with the City provided that montly payments should be made as the improvement progressed and that payments should be made upon these monthly estimates, the City retaining 20% of the amount earned and paying the contractors 80% of the monthly estimates. This contract was of record in the City Clerk's office during all of the time that plaintiff was engaged in furnishing the material in question, and the record further discloses that this provision of the contract was carried out by estimates being furnished by the City Engineer

monthly, based upon the amount of work and material which had gone into the improvement during the previous month and that upon these estimates being filed with the proper officers of the City either money or bonds were issued up to 80% of the completed improvement; and the record further discloses without contradiction that under an arrangement made between the contractors and the Vancouver Trust & Savings Bank the money which was paid upon the monthly estimates was paid to the Vancouver Trust & Savings Bank. The record will further disclose that before the work commenced Rector & Daly made an assignment to the Vancouver Trust & Savings Bank of all of the money which should come to them for this improvement, and that the bank in consideration thereof agreed to advance money to Rector & Daly based upon the monthly estimate for the purpose of paying for labor and material which went into the improvement, and that during the time the plaintiff was furnishing the material involved in this action the Vancouver Trust & Savings Bank received from the City on account of the improvement in question over $22,000.00. The record further discloses, and on this point there is no contradiction, that during this time the plaintiff received from the Vancouver Trust & Savings Bank checks which were turned into cash amounting to $7312.15.

It is our contention that the evidence stands uncontradicted that the money which plaintiff received from

the bank was money which was advanced by the bank to the plaintiff against the estimates as the work progressed on the improvement of the street, and is directly traceable to that fund.

The first payment for the crushed rock was the sum of $662.50. This the defendants are given credit for by the plaintiff. The next payment was a check for the sum of $1216.25 and was paid by check dated August 8 1911, and is defendant's "Exhibit No. 1"; this check had endorsed on it "7/5-483 y C Rock 603.75

7/6-490 y C Rock 612.50

1216.25"

It is admitted by plaintiff on page 39 of the transcript of record that this crushed rock went into this improvement and is a portion of the material that plaintiff is suing for in this action; Hackett, however, contends that after this check was received by the plaintiff at its office in Portland he discovered this crushed rock endorsement and that he called Rector on the phone and in a conversation with him it was then agreed that it might be applied on the sand and gravel account.

The district court in passing on this particular payment held that the application made by Rector & Daly at the time the check was issued constituted such an application as could not thereafter be changed to the prejudice of the sureties, using this language:

"It operated *instanter* to discharge the liability of the sureties *pro tanto,* and while plaintiff and Rector and Daly might thereafter, as between themselves, change the application of such payment, it would not operate to revive the extinguished obligation by defendants." (Citing authorities.)

This is undoubtedly the rule, and counsel in their brief do not seem to question the soundness of the doctrine announced by the court relative to this particular check. So that on the question of application of payments this check must be considered as a payment for crushed rock because of the direction which was made upon the check at the time it was issued and delivered to the plaintiff, but if the court is wrong in its application of this principle of law to this check we still have the testimony that at the time the check was given it was issued directly against the B street assignment.

Mr. Evans testifies on pages 113, 120 and 121 of the transcript of record, that at the time this check was presented it was not paid because of want of funds and went to protest and that at that time Rector & Daly had overdrawn their account in the sum of $661.93, and that a note was taken by the bank to cover the amount of the check, and that that note was based against the assignment on East B street; it further appeared that some collateral security was given at this time, but that the

collateral was of no value and nothing was collected from it. Rector & Daly's account at the time they issued the check showed that they were overdrawn $661.93 and that before the check was paid a note was given based against the assignment of the B street estimate and that the check was taken care of from the proceeds of the note.

There was another payment of $1000.00 made on October 10, 1911, which is defendant's "Exhibit No. 2," about which there can be no contention and which counsel do not seriously question in their brief. The lower court in its decision in passing upon this particular payment, says, 215 Fed. Rep., 618:

> "A short time before Rector & Daly abandoned the contract to the sureties plaintiff refused to surrender one of the barges of rock now in suit until $1000 was paid, for which amount one of the checks in question was given; this alone is sufficient to show that it should be applied in part payment of this account."

There is some contradiction of the testimony upon this check, but here the court had the witnesses before it and an opportunity of weighing their testimony and passing upon their credibility and after hearing them testify uses the language which we have just quoted.

The officers of the plaintiff corporation deny that

this particular payment was made as contended for by the defendants, but the evidence is overwhelming that the finding of the court as stated above was justified and is borne out by all of the circumstances surrounding the delivery of this particular barge of rock. The evidence discloses that at this time plaintiff was not furnishing any sand or gravel to the contractors, the only material which was being furnished was crushed rock, and according to their testimony there was only a small balance due for sand and gravel.

Rector, a witness called by the plaintiff, on cross-examination, on page 74 of the transcript of record admitted having previously testified at another trial as follows:

"Q. Do you know if any of the portion of the bonds which you received from East B street went to the Columbia Digger Company?

A. I think $1000.00 went to the Columbia Digger Co.

Q. Credited on its account?

A. I think so.

Q. That is all they ever got out of the East B street improvement?

A. I think so.

Q. What do you base that on?

A. For the reason that we borrowed one thousand

dollars to pay the Columbia Digger Company; the last we borrowed from the Vancouver Trust & Savings Bank, Mr. Daly borrowed that.

Q. That is true, is it not?

A. If I testified to it, it is."

Further examination of this witness will disclose that he substantially admits that the last one thousand dollars was borrowed for the purpose of paying for a barge of rock which was furnished by the plaintiff and which is included in the amount which plaintiff is suing for.

The testimony of Mr. Evans and Mr. Daly shows conclusively that the money represented by defendants' "Exhibit No. 2" was got from the bank for the purpose of making the payment for the barge of rock which plaintiff refused to deliver until the payment was made. This is further strengthened by the fact that in a statement which was rendered to these defendants, which is referred to in the testimony of John J. Caspary on page 133 and which is known as defendants' "Exhibit No. 15," the defendants were given credit on the crushed rock account for $1000.00 on October 11, 1911; this statement was rendered on November 1st, 1911.

This shows that on November 1st, only about twenty days after the check for $1000.00 was received, that the plaintiff itself credited this $1000.00 to the crushed rock account.

This testimony, in connection with the testimony of Mr. Evans and Mr. Daly and Mr. Rector, establishes beyond question that this $1000 was received by the plaintiff in payment of a barge of rock, and that the defendants are entitled to credit for that amount. These two checks, one for $1216.25, which was applied by Rector & Daly, the other a check which was drawn for $1000, which was received in payment for a barge of rock, are beyond any reasonable grounds of dispute, and even counsel in their argument do not seriously question them, if we understand their brief.

The next check about which there is any dispute is defendants' "Exhibit No. 4," dated July 17, 1911, for $859.90. At the time this check was given the account was overdrawn $2565.45, and Mr. Evans testifies on page 115 of the transcript of record that this check was paid by a deposit made on July 18th; and that a note was given for $2079.40 to make up this deposit, and before the note was given Rector & Daly had overdrawn their account $2565.45; that they gave their note for $2079.40, which was made up of estimates on Fourth Plain for $990.40, East B Street $574.20, and Connecticut Avenue $514.80. The lower court in passing on this particular check in its decision above referred to held in substance that at least defendants were entitled to a credit of $574.20, the amount that went into the note that was based upon the estimate coming from this particular

street. This evidence stands entirely without any kind of contradiction and establishes that out of this check, which is defendants' "Exhibit No. 4" the defendants were entitled to a credit of $574.20.

Defendants' "Exhibit No. 5" was a check for $1017.49. Mr. Evans testifies, transcript pages 110, 111 and 112, with reference to this payment that at the time this check was issued several other checks were drawn by Rector & Daly and that their account was overdrawn $1327.79 and that in order to pay the note Rector executed a note to the bank for $2300.00. This was entered on the note record of the bank as follows: "Entered on July 7th; Rector & Daly endorsers; security collateral estimates East B Street No. 811, dated July 6th, 1911, payable on demand, $2300.00, nine per cent interest."

Thus the Court will see that at the time this check was paid it was paid out of funds which were secured by these estimates on this street, and that at that time there were no other funds out of which it could be paid, but it was directly paid by an advancement which the bank made, based upon the estimates made upon East B Street. This record stands undisputed and there is no contradiction but that this check was paid out of money which was advanced by the bank to Rector & Daly and based upon a note which was secured by assignments of estimates on East B Street.

The next payment was the sum of $3000.00 paid on September 6th, 1911. At the time this check was presented it was marked not paid for want of sufficient funds; and at that time there was a balance to the credit of Rector & Daly as testified to by Mr. Evans on page 114 of the transcript of record, amounting to the sum of $375.88, and that in order to meet the payment of this check which had been refused payment because of insufficient funds Rector gave his note to the bank for the sum of $4000.00 against the estimates on East B Street and the money was paid based upon that estimate. No one testified to the contrary and that testimony stands uncontradicted.

The next check, in the order in which we are considering them, was dated June 23rd, for $501.64. At the time this check was paid Mr. Evans testifies on pages 115 and 116 of the transcript of record that the contractors had overdrawn their account at the bank and that they gave the bank a note for $5770.00, secured by estimates for work done on East B Street and $1115.75 in money that was paid in, so that at least a portion of this check should be chargeable to this fund. But, leaving out of consideration this check, we have the payment of $1216.25, Exhibit No. 1; $1000.00, Exhibit No. 2; $574.20, Exhibit No. 4; $1017.49, Exhibit No. 5; $3000.00, Exhibit No. 6, making a total of $6807.94, and the original amount sued for in this action was

$6189.88, making an excess of payment amounting to $618.06. Thus, leaving out the $501.64, defendants' Exhibit No. 7, there would be sufficient, and more than sufficient, without considering the $574.20 which was included in Exhibit No. 4, to offset plaintiff's claim.

It is our contention that a careful examination of the record and the surrounding circumstances will convince the court that the plaintiff had an agreement with Rector & Daly that the moneys which they received from Rector & Daly from this improvement should be applied toward the payment of the unsecured claims and the plaintiff would look to the bond to secure the payment for the crushed rock. Every circumstance indicates this.

It is evident that the plaintiff was aware of the financial condition of these contractors and was unwilling to trust them to any considerable extent. The officers of the plaintiff corporation have testified, as heretofore cited by us, that they would not furnish this rock until after they had made an investigation and found that there was a bond with responsible sureties which they could look to to secure payment.

It also appears from their testimony that they were buying this crushed rock from a gentleman by the name of Hume and had to pay for it, and that they were unwilling to furnish it until they knew they were amply secured.

The testimony already quoted discloses that the plaintiff was to be paid for the sand and gravel first, and was to look to the bond as security for the payment for the crushed rock because, as the witness Hackett says in his testimony, that before he would furnish any crushed rock he came to Vancouver and learned that there was a good and sufficient bond to secure payment for the crushed rock. We submit then that it is fair to conclude that Hackett having this knowledge that plaintiff was amply secured for the crushed rock, then representing the plaintiff corporation, made this arrangement with Rector & Daly to furnish them sand and gravel, and that they would pay him for it as they went along, because he was unwilling to trust them for any large amount, but that he would trust them for the crushed rock because he felt the plaintiff was amply secured under the bond.

On pages 37 and 38 of the transcript of record, on cross-examination, Mr. Hackett testifies as follows with reference to a conversation had with Rector over the application of the payment of the check for $1216.25: "We are not expecting any money on the rock, and we want our sand and gravel paid for first." What does that mean? It simply means that he would not take chances on the payment for sand and gravel, but wanted his money for that first because he had the bond to rely

upon for the crushed rock; indeed, this is what he admits.

Again quoting from the same witness on page 38:

"Q. This was given you as payment for crushed rock which went on East B street, wasn't it?

A. Well, I told Mr. Rector that I wanted to pay for my sand and gravel first, that I had no security for it.

Q. That is the idea exactly.

A. And that this check had marked on it 'for crushed rock' and that I did not want that; that I wanted him to pay me for the sand and gravel," etc.

This, we think, clearly shows that our contention that plaintiff expected and intended to apply all payments received by it from whatever source to the unsecured claim, and, as shown by the testimony, refused to make any other application until the sand and gravel were paid for.

Again, we call the court's attention to the testimony of Mr. Rector, on pages 86 and 87 of the transcript; he admitted that this testimony was given in the trial of the case of *Sparks & Blurock vs. Vancouver Trust & Savings Bank,* in the superior court of Washington.

"Q. Did you have an arrangement with the Columbia Digger Company that you should do that and let the crushed rock account stand because you had a bond to protect you?

A. I think probably we did."

Again

"Q. When did you make this arrangement with the Columbia Digger Company that cash should go on the sand and gravel and the bondsmen stand for the crushed rock?

A. May or June, 1911."

This testimony of Rector is in keeping with the conduct of the plaintiff and is substantiated and corroborated by all of the circumstances surrounding this matter.

As further evidence of this arrangement we would call the court's attention to the testimony of Caspary, the bookkeeper for plaintiff, on pages 70 and 71 of the transcript. An examination of his testimony will disclose that on July 10th they reecived a check from Rector & Daly on account of crushed rock amounting to $662.50. This is the check which later plaintiff credited to the rock account, but at the time this check was received, as shown from the testimony of this witness and by reference to Exhibit No. 15 at the top of page 182 of the

transcript this check was credited to the sand and gravel account and was never credited to the rock account until after preparation was made for this suit.

As further evidence of this we would call the court's attention to plaintiff's Exhibit No. 16. This was the statement furnished by plaintiff to the defendent on December 30, 1911, for the balance due for crushed rock and in that statement there is a claim for this 530 yards of crushed rock at $1.25 per yard, amounting to $662.50. The bookkeeper has undertaken to explain that he made a mistake, but the plaintiff failed to produce any books showing any application of these payments, and these statements were rendered as copies of the books and show how the plaintiff was applying these payments as they were made and the reasons for it.

This testimony must convince the court that it was the intention of the plaintiff not to credit any payments upon crushed rock, although the check was received in payment for a barge of crushed rock amounting to just this sum, until after all of the sand and gravel had been paid for; and the same was true of the check for $1216.25, being defendants' Exhibit No. 2. As already noted, this check had endorsed on it that it was a payment for a barge of rock amounting to just this sum, but the plaintiff upon noticing this endorsement refused to apply it in that manner until after the sand and gravel account was paid for.

The evidence and all of these circumstances must convince the court that the plaintiff had an understanding and followed out the plan of using the money that came from payments made on this improvement, towards the settlement of the unsecured claims and did so at the time with the intention of relying upon the bond as security for the payment of the crushed rock. But it is our position that it is not necessary for us to show that such an arrangement was previously entered into, if, as a matter of fact, the money which the plaintiff received came from this improvement, for then plaintiff was bound to apply it towards the payment for the material which went upon this street and could not apply it toward the unsecured general account, or towards any other indebtedness due from Rector & Daly.

The lower court did not make any finding that plaintiff knew that the payments in question were, in fact, realized under the contract with the city, for the court was of the opinion that such a finding was not necessary; but the court did say, quoting from its decision, "Knowing these things would doubtless constitute reasonable grounds for belief upon his part that such payments were from that source and was enough to put him upon inquiry as to the source from which they were derived."

The court here refers to the fact that part of the checks were marked "for crushed rock" and the fact that in the testimony of Mr. Hackett, president of the

plaintiff corporation, he explained that the agreement was that the rock was to be paid for as soon as Rector & Daly got their money off of B street. In further proof of the fact that plaintiff knew that money was being received by Rector & Daly from this improvement we would call the court's attention to the fact that the plaintiff knew that this work was being prosecuted as a public improvement and that the statutory bond mentioned had been given, because he says that before he would furnish any rock he came to Vancouver and learned about the bond and the financial responsibility of the sureties.

The contract which this bond was given to secure provided for monthly payments based upon the estimates of the City Engineer. This contract was a matter of public record on file in the City's Clerk's office and was the very contract which these sureties had undertaken to guarantee performance, and we contend that it is a matter of general custom prevailing throughout this section to such an extent that plaintiff is deemed to have had notice of it, that the payments on public contracts of this character are made from time to time on estimates given by the engineer in charge; besides, the plaintiff was furnishing materials for the performance of the contract and is bound to take notice of the terms and conditions of the contract and in legal effect had notice of its terms and conditions and was bound by all

of its provisions, and one of its provisions was that payments were to be made from time to time based upon estimates of the engineer.

The liability of the sureties was measured by the statutes providing for the giving of this bond and the provisions of the contract and one dealing with the contractor was bound to take notice of the provisions of the contract so far as the rights of the sureties are concerned. We will call the attention of the court to the fact that there was no contractural relations existing between these parties, and that persons furnishing material or labor were protected only by reason of the giving of this bond. It is our position that the bond and contract must be construed together and the plaintiff must be held to have been aware of its provisions. Before the plaintiff would furnish any rock for this improvement it satisfied itself of the financial responsibility of the bondsmen and doubtless knew of the financial condition of the contractors.

How did it expect that these contractors were going to perform this entire contract without receiving payments from time to time, in their financial condition? The plaintiff itself refused to deliver any crushed rock without knowing in advance that it was protected by this bond, and it is fair to assume then that other persons furnishing material would be equally cautious. Could plaintiff expect this contract could be carried on and this

large public improvement completed if no payments were made from time to time in order to meet the pay-roll and part payments for material that was being used? We submit the long experience shown to have been had by the officers of plaintiff, and the prevailing custom of handling such matters in this vicinity could not permit of such a conclusion. This contract, as was customary in similar contracts, provided for payments amounting to eighty per cent as the work progressed. The plaintiff knew of this custom, must have known of it, because it appears that the plaintiff is engaged in furnishing material for works of this character and as we have already stated was bound to take notice of this provision of the contract so far as the rights of these sureties are concerned. In addition to that we have the fact, to which we have already called the court's attention, that the plaintiff received a check, on the 10th of July, for $662.50, which was payment for a barge of rock which went upon this street and which plaintiff knew, according to the testimony of its witnesses, was intended to be a payment for a barge of rock, although it was credited on the sand and gravel account at that time. Plaintiff now is contending that that was a mistake, that it was intended to be credited to the rock account at the time it was made. Again when the check for $1216.25 which had the endorsement upon it that it was for crushed rock was paid,

plaintiff knew that payments were intended to be made for the crushed rock, but it refused to accept it on that account, according to the testimony of Mr. Hackett. And when the last payment of $1000.000 was received on October 11th plaintiff credited it to the crushed rock account, as shown by Exhibit No. 15. All of these circumstances clearly indicate that plaintiff knew that the payments were intended to be made on the crushed rock, and in fact were made by the contractors for the rock which went upon this street, but plaintiff refused to so apply them according to its contention at this time, but plaintiff admits that at least the two checks first mentioned were intended to be payments upon the crushed rock. Before the work commenced upon this improvement the contractors had assigned to the Vancouver Trust & Savings Bank the money coming to them on account of this improvement under the agreement heretofore mentioned; and that assignment was a matter of public record in the City Clerk's office, all of the checks received by the plaintiff being paid by the Vancouver Trust & Savings Bank. Here was the assignment of record of the money coming from this improvement to this bank, and payments made by the bank to the plaintiff. During the time that these checks were received plaintiff was not furnishing crushed rock to these parties for any other improvement, so plaintiff knew that these checks were intended to be in payment for crushed rock

which had been furnished upon this street, two of the checks corresponded in amount to deliveries which were furnished for this street.

These circumstances when taken in connection with the testimony of Hackett, Caspary and Rector, must convince the court that these parties were thoroughly familiar with what was being done and kept themselves thoroughly familiar with this improvement and the progress that was being made upon it, and knew that payments were being made by the city from time to time upon the engineer's estimates; they may not have known that the money which it received came directly from the city on account of this improvement, but they did know that they had an arrangement with Rector & Daly that whatever money Rector & Daly paid, whether it came from the city on account of this improvement or otherwise, would be applied on the sand and gravel account first, and they must have known that Rector & Daly were receiving money from the city as the work progressed.

The plaintiff has undertaken to deny that there was an agreement that the money which came from this particular improvement should be applied upon the sand and gravel account, but this contention is met and overcome by the testimony of Mr. Hackett himself and the other witnesses. He testifies, as already cited by us, that the arrangement with Rector & Daly was that the sand

and gravel account must be paid first, it made no difference to him where the money came from, the sand and gravel account was to be paid and the rock account was to be allowed to run and when checks were received for the payment of the rock plaintiff refused to accept them, insisting that the sand and gravel account must be paid first.

It seems to us that the court cannot avoid the conclusion from this testimony that the sole aim and purpose of the plaintiff was to keep the sand and gravel account paid up and to rely upon the bond for payment of the material which went into this street.

But we do not need to burden the court with an examination of the record to justify the contention which we have been making above, for this case can be disposed of and the judgment of the lower court affirmed upon the testimony of Captain Hackett, president and manager of the plaintiff corporation. The lower court, in its decision on this subject, quoted the testimony of Captain Hackett as taken from the transcript of his testimony. We have already quoted portions of this testimony and will not repeat it, but for the convenience of the court we will repeat the latter part of the quotation:

> "I called Mr. Hume and we went over to Vancouver and saw Mr. Rector and he said that he could not pay cash for the crushed rock, but as soon

as he got his money off of B street, why, he would pay us for the crushed rock, and that he would have to ask us to wait for money until he did get his money from B street, and we asked him what surety we would have if we waited for our money and said that he had a bond to the city to pay for all labor and materials, a good bond, and mentioned who was on the bond, Mr. Blurock and a man named Sparks, I think, and so under those conditions we thought we were perfectly safe in furnishing him the rock and waiting until he got his money off B street, so we began to make deliveries as soon as we could."

In substance this is testified to again by this witness on pages 37 and 38 where the question came up relative to the application of the $1216.25 check, and again on page 41 in the testimony of the same witness, and again on page 43, so that if we take this statement of Captain Hackett as the basis of the agreement which was made between him and Rector & Daly relative to the time and manner of payment for the crushed rock, we have this condition; that plaintiff would wait for its money until Rector & Daly got their money from B street. The agreement, then, was that when they drew their payments from the city on account of this improvement that plaintiff was to be paid for the crushed rock; and he does not here state that the agreement was that the

plaintiff was to wait until the entire work was completed and permit the plaitniff to draw this money and apply it on the sand and gravel account, he denies that that was the arrangement, although the evidence shows that was the real understanding, but it contends in effect that the contractors might proceed with this improvement and whatever money they might draw from the city on account of this improvement while the work progressed was not a matter of concern for the plaintiff so long as the sand and gravel account was kept paid because plaintiff was to wait until the contractors were paid by the city and Captain Hackett now says that he expected to wait until the entire work was completed and that he was not doing this relying upon the bond, but was waiting until the contractors received payment from the city. This contention puts plaintiff in an absurd position. In the first place he stated that the plaintiff would not furnish the material without the security of the bond, then Captain Hackett says that they were not relying upon the bond but were waiting for the contractors to get their money from the city; in the meantime all the money which the contractors were paid by the city and which was paid to the plaintiff was applied to the sand and gravel account by plaintiff. The fact is that plaintiff was relying upon the bond and sold the sand and gravel to the contractors and took the money which it received and applied it on that account, knowing that

there was a bond which protected the plaintiff for the material which went into the street; but if the contract which plaintiff claimed it had was to the effect that it should be paid when the contractors received their money from the city, then when this money was received from the city and paid to plaintiff that contract was performed and plaintiff cannot apply the money received in payment of the contract to other unsecured accounts to the prejudice of the sureties. Here the contractors performed the contract which the sureties agreed they would perform by paying the money to the plaintiff according to the terms and conditions of the agreement which plaintiff claims it had with the contractors; now it takes the position that although this money was paid by the city to the contractor for this crushed rock and that the contractor paid it to the plaintiff, that because it was paid before the final completion of the contract that it has the right to apply it in a different way.

Supposing no bond had been given under the provisions of the statute and Mr. Hackett was furnishing rock to Mr. Rector to be paid for when he received his money from the city, can it be contended that he would have allowed the money to be paid to Rector & Daly from time to time as the work progressed and wait until they had been fully paid before he would have made inquiry as to what was becoming of the money that they were receiving from the improvement, or what provision they

were making for its payment? Certainly not, in view of the fact that it was apparent from the testimony that Captain Hackett did not regard these contractors as financially sound. If no bond had been given Captain Hackett would have known all about the payments and when the payments were to be made, and where they were coming from because he said that he bought this rock from Mr. Hume and had to pay cash for it and he would not have permitted this account to run on until the entire work was completed and then trusted to the contractors to make payment, but would have insisted, as he did, for the sand and gravel, that payments should be made promptly as the material was furnished. This must convince the court that he was trusting to the bond and taking money which the contractors were receiving from this improvement and applying it on the sand and gravel account.

The contract, according to Captain Hackett, was that the sand and gravel account should be paid from the general account of Rector & Daly, but that the crushed rock account should be paid with money which Rector & Daly received from the city on account of this improvement; that is the contract which the sureties undertook to guarantee; that was complied with when payments were made, and plaintiff is not now in a position to urge that it had a right to use the payments which were made from time to time on account of this

improvement in satisfaction of unsecured claims and that it had a right to wait until the entire completion of the improvement and if there was any balance due from the crushed rock to apply it on that debt and if there were no balance then to hold the sureties liable; that is its contention in face of the fact that its witnesses have testified that payments were to be made to it when the contractors received money from the city.

The lower court takes notice of this question and we think that its decision upon this point is absolutely sound and cannot be overcome by reason or authorities. Quoting from this decision:

> " 'As soon as he got his money' means 'immediately upon getting the money.' 1 Words & Phrases, page 527. It does not mean 'As soon as he got *all* his money,' It means no more than to say 'As soon as he got money,' 'the money,' 'sufficient money,' and there is nothing in the circumstances to warrant the inference that the entire contract would have to be completed before any money was paid on it, more than to suppose that it would be paid for as the work progressed, and especially would this be true after the receipt by the plaintiff of the first check marked 'crushed rock.' The presumption would follow that the contract being that it was to be paid for as soon as the money was received under the contract with the city, that was the source from

which the payment by the marked check was being made. If plaintiff was mistaken both in supposing that the money would not be paid until the completion of the contract and in not understanding that the payments made came 'off of B street,' it was a mistake for which the defendants' sureties were in no way responsible; and where the payments from this source were diverted from that part of the account to which it was understood they would be applied, intentionally or mistakently, it is nothing for which the sureties were responsible, this being a contract plaintiff made and to secure the performance of which the bond was given, and it being in substantial accord with what the courts have held to be equitable under such circumstances there would be no authority in the principals to that contract to change it so manifestly to the sureties' disadvantage, without releasing them to the extent of the diversion. What the principals could not do directly they should not be allowed to do indirectly."

As above stated, we think that the position taken by the lower court upon this phase of the case disposes of the appeal and will warrant the affirmation of the judgment.

Counsel in their brief do not attack this position of

the court and have not in any manner met the conclusion which the court reached in its consideration of this part of the case.

They have discussed various decisions and rules but in no place have we been able to find any argument or contention which could explain away the conclusion which we think must be drawn from the position which plaintiff has placed itself in by the testimony of Captain Hackett as to the agreement which he claims was made between Rector and himself as to when the payments should be made for the crushed rock.

Counsel contend that the defendants have failed to show the money which plaintiff received came from the city on account of this improvement. The evidence stands uncontradicted that before entering upon this public work the contractors assigned the money to be received from the improvement to the Vancouver Trust & Savings Bank, that each of the checks which plaintiff received so far as this case is concerned were paid by the Vancouver Trust & Savings Bank and that all the money which plaintiff received aggregating an amount in excess of the claim for the material furnished which went into this street was money paid by the Vancouver Trust & Savings Bank; the evidence stands uncontradicted that this money was paid from credit received by the giving of notes by Rector & Daly based upon the estimate of this street and to be paid out of the estimate

of the street as the estimates were received from time to time. We have traced the credit from the contractors to the bank; we have traced the cash payments from the city to the bank, of $10,046.17, Exhibit No. 9, of bonds which under an agreement with the contractors were to be sold at a discount and cash received from the sale of the bonds to be used on account of this improvement to the credit of Rector & Daly. The bonds so received amounting in the aggregate to $11,500.00, being defendants' Exhibits 10, 11 and 12; these were sold at a discount of 12½%. In addition to that we have shown that the bank received on this account several thousand dollars due on account of final payment of the street and which resulted in litigation between Sparks & Blurock and the Vancouver Trust and Savings Bank.

The record will disclose that although Rector & Daly had a general checking account with the bank that at the time the checks which went to plaintiff were paid there were no funds to the credit of the contractors and that before any of the checks were paid a note was given to the bank by Rector & Daly to cover the amount of the payment and that the note was made a specific charge against this B street improvement. There was no evidence offered to the contrary; and the testimony of Mr. Evans on this subject was competent; the books were present in the court room about which he was testifying and there are no possible grounds for the contention

of counsel that this evidence was incompetent; they make no suggestion which would make it incompetent except that some of the matters that he testified about were not within his personal knowledge, but the books were present in court, books kept in the ordinary course of business, the books containing these accounts in this matter and the part of his testimony which referred to these notes was within his personal knowledge or appeared from the records of the bank, and the original records of the transaction. This was clearly competent, and this evidence together with the records clearly established the facts as given above.

The lower court in passing on this matter used this language:

> "The foregoing is sufficient to show the substational identity of the money paid plaintiff with that realized by Rector & Daly under their contract with the city. Plaintiff contends that it was not realized from this work, that the money paid plaintiff was raised by Rector & Daly upon their credit and that no money was paid by the city until long after the payments to plaintiff. If such an exact identity in the fund were ever required it would be seldom attained. If this money advanced to Rector & Daly was not realized from this work, then Rector & Daly never obtained any money under it, yet they had, and disbursed thousands of dollars ad-

vanced under the obligations for that work and so realized under it."

This quotation is from the court who tried this cause, and after it had had the witnesses personally before it and after full opportunity of passing upon the competency of the testimony which went to show the identity of the note. The law does not require in order to relieve the sureties that they show that the identical money which the city paid for the improvement was received by the materialman, it is sufficient to show that the money was paid to the contractor and by him placed to his credit in the bank and that the materialman was paid from this credit. It is not necessary that the same identical piece of coin should pass from the city to the materialman, but if the money is paid to the contractor and he places it in the bank to his credit and from that credit pays the materialman this is sufficient to establish payment. The evidence in this case does not disclose any commingling of the funds received from the city on account of this improvement with other funds of the contractors; the contractors had no funds at the time these checks were paid, they had no funds that could be commingled with the money received from the city. The money was not received at the time the checks were paid, but under the agreement between the bank and Rector & Daly the bank was to advance the money to Rector

& Daly based upon the engineer's estimates; the checks were paid directly against these advancements, the money was not paid out of a general account commingled with other funds because, as before stated, these contractors at the time the checks were paid had no funds; in each instance they were overdrawn and it was necessary to give a note based upon estimates from this street in order to pay the checks.

The courts hold that it was necessary for us to show with reasonable certainty that the money received by the bank which paid these checks came from the city. There is no question of reasonable certainty here, there is no dispute, no contradiction, the evidence is plain just how these checks were paid and it stands unimpeached that they were paid from money derived against the estimates on this street under the agreement which the bank had with Rector & Daly. A clearer case of following funds from the city to the materialman could hardly be conceived unless you took the original coin and passed from the city to the materialman, which is not required.

In the case of *Merchants Insurance Co. vs. Herber,* 71 N. W. 624, this question is discussed, and the court here says:

> "We are not to be understood as holding that it was necessary for the surety to show that the identical money received for such premium was applied

in payment of the checks. It would have been sufficient for him to have shown that money was in fact collected for such premiums and paid into the common fund in the bank and that it remained a part thereof until the checks were paid. The burden was on the surety to establish with reasonable certainty that the money received for the premiums for which he was liable on his bond was in fact a part of such common fund and was used to pay the prior indebtedness of his principal."

Here the court says that it was necessary to show with reasonable certainty that the money for which the surety was liable was in fact a part of such common fund and so used to pay the prior indebtedness of his principal. In the case at bar there was no other fund, or funds; and all checks were paid from money advanced by the bank on account of the improvement; and hence there is no question of commingling of funds in this case, there being as above stated, but the one fund.

Again, in a concurring opinion in this same case, the concurring judge used this language:

"True it appears the trust fund received by Herber from various sources together with his commissions were deposited in one account in the bank and thereby commingled. Plaintiff would have a right to trace the moneys belonging to it into this

common fund and recover them back out of it, and these sureties also have a right to trace into this fund and out of it the money received of Herber for which these sureties are liable."

We have traced the money from the city into the fund and out of it and have shown from what source the money came which went to the plaintiff for which these sureties are liable.

On pages 29-33 of their brief counsel have cited the court to a number of decisions which establish a rule which counsel contend is decisive of this case.

The rule as given by counsel on page 32 is that money has no ear-marks and that where money is wrongfully received and paid by the wrongdoer in payment of his own debt the court cannot disturb the application of such payment where the person receiving the money had no knowledge of the owner's rights, even though the money is received in payment of an existing debt. Some of the decisions cited by counsel establish this rule and we have no quarrel with counsel over the rule as it is enunciated in these decisions, but the rule has no application in this case. It is true that when a person pays money which he has wrongfully acquired that such payments cannot be followed and the person receiving the money held responsible for it where he had no knowledge of where

the money came from but that rule has no application here.

We are not seeking to recover money from the plaintiff which Rector & Daly wrongfully received from some source and gave to the plaintiff in payment for a debt, but here the sureties agreed that Rector & Daly would pay the plaintiff for the material which it furnished which went into this improvement and we have a right to show that they have made such payment and for that purpose we may show where the money came from which Rector & Daly used in making the payments in question.

These sureties did not undertake to secure the payment of promiscuous claims which might be due and unsecured from Rector & Daly, or any claims other than the one which was the subject of the contract, viz., claims for the improvement of B street, and they have the right to show that their undertaking in this regard has been complied with. If the general rule is as stated by counsel then this case falls without rather than within the reason of the rule and is not governed by the decisions cited by counsel.

There was another principle announced in the case of *Holly vs. Missionary Society,* 180 U. S. 284, which seems to be the leading case cited by counsel on this question which takes from that case its weight as an authority on this question, and that is, that a court of equity will

not transfer a loss that has already fallen upon one innocent party to another party equally innocent, where the equities are equal. In the case at bar there is no such thing as an equality of equities, the plaintiff by the position it has assumed pursued a course which would inevitably require the sureties to pay for the material which went into this street; its conduct in this regard was an actual fraud upon the rights of these sureties. It claimed it had an arrangement that whatever money Rector & Daly paid it should be applied on the sand and gravel account, a debt for which these sureties were not responsible, and when it received payment for rock furnished, it refused to accept a check but insisted that such payment should be applied on a debt for which the sureties were not liable. Such a course was bound to ultimately force the sureties to pay the plaintiff for the material which went on this street, because if the contractor was using the money which came from this street and paying it to plaintiff for other debts then the fund which came from this improvement would be exhausted and plaintiff would be forced to rely upon its bond, which it is doing. In making this arrangement with the contractor without the knowledge of the sureties it was perpetrating a legal fraud upon these sureties and certainly it is not entitled to any consideration so far as the equities of the matter are concerned.

Where the rights of third parties, such as sureties, are involved, the courts have not followed the rule announced by counsel, but permit evidence to show out of what funds the payments were made.

In *U. S. vs. January,* 7 Cranch 572; 2 Curtis' Rep. 673, the Supreme Court of the United States in passing upon the liabilities of sureties on official bonds for different periods of time for the same officer, used this language:

> "It will be generally admitted that moneys arising, due and collected subsequently to the execution of the second bond cannot be applied to the discharge of the first bond without manifest injury to the sureties in the second bond; and vice versa, justice between the different sureties can only be done by reference to the collector's books and the evidenc which they contain may be supported by parol testimony, if any, in possession of the parties interested."

In *First National Bank vs. National Security Co.,* 131 Fed. 401, the Circuit Court of Appeals, speaking through Justice, then Judge, Lurton, used this language:

> "But this is not Clayton's case and is quite distinguishable from it, by reason of the fact that this is not a question as to the fund out of which a check

is presumably paid; but one of the application of deposits and the more important fact that the rights and equities of a surety for a limited period cannot be ignored when we come to the appropriation of payments."

And again,

"The general rule of applying every unappropriated payment to the oldest item of debt is subject to qualification where the rights and equities of third persons are involved."

Counsel have cited in support of the rule mentioned above the case of *Tanner vs. Lee,* 49 S. E. 592. We have not this case at hand and are not in a position to examine it, but in the case of *Young vs. Swan,* reported in 69 N. W. 566, the Supreme Court of Iowa held exactly the contrary to what counsel states is held in *Tanner vs. Lee.* The court says:

"The wife furnished the husband money with which to buy a bill of lumber. The husband goes to a materialman with whom he has a general account, purchases the lumber, pays the money which his wife has given him to the merchant and the merchant applies it upon the general account. Can he now in an action to establish and foreclose a mechanic's lien against the property of the wife, insist

> that these payments with the wife's money shall be applied upon the husband's general account to the detriment of the wife? We think not."

This case applies with considerable force to the question now before the court because the bond stands in place of the property upon which a lien could be enforced and takes the place of the lien. Here, the sureties undertook that Rector & Daly would pay for this material; they did pay for it from the fund on account of which the sureties became liable, but the plaintiff is attempting to apply it on the general account. The court did not base this case upon any question of notice as to where the money came from, it simply held that the money belonging to the wife could not be misappropriated in that manner.

In *Crane Bros. Manufacturing Co. vs. Keck,* 53 N. W. 606, the Supreme Court of Nebraska said:

> "As between the debtor and creditor there is no doubt but the rule that where a debtor fails to designate a debt, where there are several debts upon which a payment may be applied, the creditor may apply it; where, however, the rights of third parties intervene the rule does not apply. Thus, where A was a creditor of a firm, and also of a surviving partner thereof, individually, and the latter made

> a payment out of funds belonging to the firm without designating the debt on which it should be applied it was held that as the funds belonged to the firm they must be applied to the partnership debt."

In *Lee vs. Storz Brewing Co.,* 106 N. W. 220, the Supreme Court of Nebraska affirmed the decision last cited and held that

> "Where the money was received by the debtor from a third party whose property would be liable for the debt in case the money was not applied upon the third party's liability there was an exception to the general rule."

From a review of the decisions where the rights of sureties have been involved on official bonds and other similar liabilities the court will see that the rule cited by counsel has not been followed but that evidence has been permitted to show the source from which the payments were made.

Next considering the principles which govern the court in determining the application to be made of the payments in question, we would call the court's attention to this principle of law, that

> "In making application of payments the principles of equity are recognized at law so far as the

nature of the proceeding will admit. 30 *Cyc.* 1240 (3).

The general rule is that where no appropriation of the payment has been made by either debtor or creditor of a payment the law will apply the same according to the principles of justice and equity in the particular case, provided there are no other parties interested, and while the word "equity" is used by the courts when expressing a rule given by them they apply it in the sense of the word right and justice and other words of the same import, and in the enforcement of the principle apply it to legal defenses.

A rule which we contend applies to the case now under consideration is analagous and governed by the same rules which apply where neither debtor or creditor has made application and the court makes it according to the principles of justice and equity.

Under this rule the law makes the application and the parties are not at liberty to make a different one from that which the law establishes as the correct rule governing situations and transactions of this character and the court follows the law in making application, the law makes it according to the rule of justice and equity.

This principle was very early adopted by Supreme Court of the United States and has been uniformly ad-

hered to by that court. In the case of *U. S. vs. Kirkpatrick,* 9 Wheaton' 720, 6 Curtis 244, the court used this language:

> "The general doctrine is that the debtor has the right if he pleases to make an appropriation of payments, if he omits it a creditor may make it, if both omit it the law will apply the payments according to its own notions of justice."

The court speaks for the law and makes the application according to the law's views of justice.

In the case of *U. S. vs. January, supra,* the same rule was followed.

> "The general rule is that the court will make the application in such a manner in view of all the circumstances of the case as is most in accord with justice and equity and will best protect and maintain the rights of both debtor and creditor." 30 *Cyc.* 1240.

> "Equitable principles so far as applicable to our conditions and not changed by statute have been adopted as a part of our common law. * * * It has been held that whenever a right claimed under the rules of common law has been denied, governed or controlled by the principles administered by the

courts of equity the latter will prevail over the former and it is the duty of the courts in administering justice to decide and render judgment accordingly."

There is another principle of law which we desire to call the court's attention to and which we think is very important in the consideration of this case, and if our view of the testimony is correct it is of controlling importance, and that is this:

"It is a familiar law that any change in the contract of a surety or in a contract for the performance of which surety agrees to be liable whereby attempt is made to increase his contractural liability without his consent, releases the surety."

This quotation is taken from the case of *Eberhart vs. U. S.*, 204 Fed. 884, and in support of the rule three decisions are cited; one of these is *Reese vs. U. S.*, 9 Wallace 13. The decision is by Justice Field. In this case a bond was given for the appearance of persons charged with a crime. The government without the consent of the sureties entered into a stipulation that the defendants might depart without the territory of the United States into foreign countries and remain there until certain civil cases pending in another court were disposed of,

The Supreme Court of the United States held that by this action on the part of the government the sureties were released. This quotation is taken from this decision:

> "And the law on these matters is perfectly well settled. Any change in the contract on which they are sureties made by the principal parties to it, without their assent, discharges them."

Another case cited in support of this rule is *Smith vs. U. S.*, 2 Wallace 219.

> "Any variation in the agreement to which the surety has subscribed which is made without the surety's consent and which may prejudice him or which may amount to the substitution of a new agreement for the one he subscribed will discharge the surety."

As already quoted Rector while testifying in the case tried in the superior court here at Vancouver admitted that an arrangement was made with the Columbia Digger Company that the money which the contractors received should go on the sand and gravel and the bondsmen stand for the crushed rock. Captain Hackett in testifying for the plaintiff denies that arrangement but does state that the sand and gravel was to be paid in full and the rock account was to run, and he also testified

that he came to Vancouver and ascertained that there was a good and sufficient bond which would secure him for the rock; he further testifies that when he received a payment upon the crushed rock that he refused to accept it as such but insisted that it should be applied on the sand and gravel account. It thus appears plain that it was the arrangement between these parties that the sand and agravel account should be kept paid in full regardless of where the money came from and that the plaintiff would rely upon the bond.

The sureties undertook that Rector & Daly would pay for the material which went into this street, but for nothing else. Here the plaintiff and the contractors adopted a course which was bound to render the sureties liable on their bond, because they were taking the money which came from this improvement and applying it on another debt. This agreement which plaintiff had with the contractors in effect extended the liability of the sureties and by reason of this arrangement imposed a liability upon them from which there was no escape if they were permitted to carry out the arrangement which plaintiff undertook to carry out and which it is now contending it had the right to carry out. This constituted a variation in the agreement which necessarily prejudiced them and which amounts to a substitution of a new agreement for the one they signed and under the decisions cited releases them from liability.

The rights of sureties under these statutory bonds have been determined and construed in a number of decisions. One of the earlier and leading cases on this subject is *Prairie State National Bank vs. United States,* 164 U. S. 227, 17 Sup. Ct. 142. In this case the decisions cited above are referred to and with reference to the doctrine of those cases the court says:

> "The rulings of this court has been equally emphatic in upholding the right of a surety to stand upon an agreement with reference to which he entered into his contract of suretyship and to exact strict compliance with its stipulations."

The court in this case held that the sureties on a government contractor's bond were entitled to be subrogated to the rights of the government over an assignee of the contractor for the money retained by the government and not yet paid to the contractor.

This decision is quoted by this court in *First National Bank of Seattle vs. City Trust, Safe Deposit & Surety Co.,* 114 Fed. 529. This last decision was an action against a surety under a bond given under the provisions of the statutes of Washington and under the same statutes which are involved in the case now under consideration. This court held that the surety was subrogated to the extent necessary to protect it from loss, to all the rights which the city might have asserted against the

funds in its hand and was not limited to the sum reserved by the city until the completion of the contract, but extended to the entire sum and was superior to an assignment made by the contractor and that the surety's right was superior in law and equity to that of the bank under its assignment, and, referring to the case of *Prairie State National Bank vs. U. S.,* supra, used this language:

> "The court held, however, that the claim and equity of the surety arose when he entered into the contract of suretyship and that his right to the reserve fund was prior and paramount to that of the bank, and said that the stipulation in the building contract for the retention until the completion of the work of a certain portion of the consideration 'is as much for the indemnity of him who may be guarantor of the performance of the work as for him for whom the work is to be performed; *that it raises an equity in the surety in the fund to be created.*' "

This court further held:

> "It is clear that the lien of the surety company upon all funds now retained in possession of the city applicable upon the contract had its inception at the time when it entered into the contract of suretyship and that subsequent to that date the contractors McCauley & Delaney had no power to

> create a lien upon the payments to be made by the city and make it paramount to the lien of the surety."

And again:

> "One who becomes a surety for the principal upon such a contract as is disclosed in this case may not be deprived of his lien by the secret contract or agreement into which his principal may have entered."

The court further held that the contractors undertook to pay all claims for work, labor and material, that the sureties guaranteed that the contractors would pay "all just claims for work, labor and material furnished in the execution of the contract;" the surety's obligation to pay liens and claims outstanding when the contract was abandoned was not limited to the extent of the reserved thirty per cent of the money then earned by the contractors, but it included the full sum of the unpaid claims. This court here holds that the sureties on the bond have an equity in the fund which was to be paid on account of the improvement. If the sureties have an equity which would entitle them to be subrogated to the rights of the city, and if that equity extends to such sums as would protect them for liabilities which they might be called upon to pay, then it seems to us that it

must follow that they have such an equity in the fund which the city pays to the contractor that their rights cannot be ignored when the contractor uses this fund in making payment for the material which is used in the improvement, and this equity which the sureties have in this fund distinguishes these cases from the general rule of the application of payments.

It is contended by counsel that this money belonged to Rector & Daly and they could make such use of it as they might see fit and that any payments that they had made on any other liabilities was no concern of the sureties. That contention of counsel is true as to money which went to other general creditors, but here the sureties agreed that the contractors would pay the plaintiff for his material; they had an equity in the fund to the extent necessary to pay this claim and when the money was received in which they had this equity and was paid to the person on whose account the bond was given, then the rights and equities of the sureties must be taken into account and the materialman cannot use the funds thus received on any other account or to pay unsecured claims against the rights and equities of the sureties.

Counsel in citing their authorities have failed to apply this principle. Some of the cases have discussed the equities of the sureties, but these are not cases where the sureties undertake to see paid a particular debt

growing out of a particular fund in which they have a superior equity.

Here we agree that the contractor will pay for this particular material and we have an equity in the particular fund which the city pays for this material to the contractors and when that particular fund that we have an equity in is received by the person who furnishes the material and on the liability for which we are surety, then the rights and equities of the sureties are superior and must be respected by the materialman and differs from ordinary payments made by the principal on ordinary liabilities, even though the sureties might have equities in the payments.

As was said by Judge Dunbar in the case of *Crane Co. vs. Pacific Heat & Power Co.,* 36 Wash. 95, "This case falls without rather than within the reason of the rule."

Counsel cite *People vs. Powers,* 66 N. W. 215, in support of their contention. This case does support their contention but so far as we have been able to discover is about the only decision which can be found which does, unless it be the case of *Thacker vs. Bullock,* 131 S. W. 271; we have not access to that opinion and are unable to state just what it holds but we assume that it agrees with *People vs. Powers,* and there may be one or two more which to some extent support their contention,

but not directly. *People vs. Powers* is referred to in 32 *Cyc.,* page 171, and the rule as given by *Cyc.* is as follows:

> "Where a surety has become responsible for the payment of money by the principal and the latter receives money under his contract which he pays over, the creditor or obligee has no right to apply said payments in any other way than to the relief of the surety."

This is given as a general rule and decisions cited in support of the rule, and the case of *People vs. Powers,* supra, is given as contrary and is the only decision which *Cyc.* cites as contrary to the rule which is given by the author of that work as the correct rule and one supported by the weight of authority.

Counsel cite 30 *Cyc.* 1250, but we would call the court's attention to the same volume on page 1252; after stating the general rule as cited by counsel the author uses this language:

> "These rules are subject to the exception that where the payment, with the knowledge of the creditor, is derived from such third person, or from a fund connected with the *secured debt,* it must be applied thereto."

And in a note:

> "The proceeds of collateral security given to secure a note cannot be applied to other debts of the maker but must be applied on the note to the exoneration of the sureties," citing *Elizabeth City First National Bank vs. Scott,* 31 S. E. 819.

The case of *Union Trust vs. Casserly,* 86 N. W. 545, cited by counsel, only goes to the extent of holding that where no application is made the creditor may apply the payment on an unsecured claim and file a lien for the last items furnished. This decision is not out of line with what we are contending for because of the distinction which we have attempted to point out to the court heretofore, of the rights of the sureties in this particular fund, which was not present in the case last cited.

Counsel seem to place some importance upon the case of *Crane Co. vs. United States,* 132 Pac. 872.

This case is not in point for the reason that there was no evidence that the payment which the materialman received came from the school district and this point clearly distinguishes this decision from what we are contending to be applicable to this case.

An examination of the other decisions cited by counsel will disclose either this distinction or that they simply

follow the general rule of the application of payments and are not applicable to this particular question.

The lower court in the case at bar cites the case of *Schwartz vs. Gerhardt,* 75 Pac. 698, 44 Ore. 425, in support of the rule that a trust fund does not lose its identity though the money changes semblance and whatsoever form it may have assumed a trust still attaches, whether it remains in the hands of an original trustee or goes into other hands, especially if the other has taken with knowledge of the trust relation. The decision referred to supports this rule, and applying this rule to the fund under consideration the sureties had an equity in the fund, that equity attached when in the hands of the original trustee, viz., the city, and followed it through the bank to the plaintiff.

In support of the principle which we contend should govern this case we would call the court's attention to the case of *Crane Co. vs. Pacific Heat & Power Co.,* 36 Wash. 95. This is the decision which counsel have attempted to distinguish and is the one which the lower court relied upon in its decision upon the merits of this case. The court here says that

> "It will be seen from the allegations of the answer in this case that the moneys applied upon the old debts by the respondent were the very moneys for the collection and payment of which the surety was

obligated to the creditor and under the rule announced by them and which seems to us to be the right and equitable rule, the surety is not bound by such application."

The court was here considering the very statutes which are involved in this controversy and had before it the same question. The court cites as supporting its position the case of *Merchant's Insurance Co. vs. Herber,* 68 Minn. 420, 71 N. W. 624, and quotes from that decision the following:

"This rule as thus broadly stated applies to cases only where the principal makes the payment from funds which are his own and free from any equity in favor of the surety to have the money applied in payment of the debt for which he is liable. Hence where the specific money is paid to the creditor and applied on a debt of a principal for which the surety is not held are the very moneys for the collection and payment of which he is obligated to the creditor, he is not bound by such application and is equitably entitled to have the moneys applied to the payment of the debt for which he is surety unless the creditor can show that he has a superior equity to have them applied as they were applied."

The authorities cited by counsel apply to the first

part of this quotation and are applicable to the general proposition as stated in the beginning of the quotation, but are inapplicable to the exception which the quotation notes. The Circuit Court of Appeals of this circuit in the case of *First Nat. Bank vs. City Trust etc. Co.,* 114 Fed. 529, held that there is an equity in favor of the sureties in the money which the city paid for the improvement, therefore we fall within the exception here noted and, the case of *People vs. Powers et al.,* supra, cited by counsel, is not within the rule announced by the decisions of the United States Courts upon this subject.

Here the very payments for which these sureties became responsible were received by the plaintiff and since this court in the cases cited has adopted the rule that the sureties have an equity in the fund under these statutory bonds this case falls squarely within the rules in *Crane Co. vs. Pacific Heat & Power Co.,* and we think is controlled by it. The lower court gave consideration to this case because it was a decision by the highest court of the state upon the rights of sureties given under this statutory bond and the court in passing on this matter used this language:

> "And while the declaration of the highest court of the state concerning such rights, equities and policy may not involve the construction of a state law, in the sense of its literal interpretation, yet it is

considered that such decision is entitled to more than ordinary consideration, if it is not absolutely controlling, where, as here, it is not directly opposed to any higher federal precedent."

Not only is this case not opposed to higher federal precedent, but it is in entire harmony with the federal decisions upon similar bonds.

The cases already cited by us show the tendency of the federal courts in determining the rights of sureties under these statutory bonds. In addition to those cited we would call the court's attention to the case of *United States vs. Am. Bonding & Trust Co.,* 89 Fed. 925, and the decision of the District Court in the same case reported on page 921 of the same volume.

The facts in this case are very similar to the case at bar; the only difference which amounts to anything is that here the notes were taken for the material furnished and the money paid by the contractor was applied upon an outstanding indebtedness, while in our case the money was applied on the sand and gravel account and the payment for the material which was furnished on this improvement was allowed to run. We desire to call the court's attention especially to this decision and to note its applicability to our case. We think it disposes of the contention of counsel and being a decision of a high federal court is entitled to more than ordinary consideration.

The court here says:

> "Indeed, as far as possible in the dealings between the parties it would seem that the materials furnished for the government building were allowed to remain unpaid for and instead thereof notes were accepted in settlement therefor continuing and extending it beyond the period for which the government payments were made upon the building, and indeed, until the contractors had failed."

So in our case, the materials furnished for the street were allowed to remain unpaid for and instead thereof plaintiff applied the payments which it received for other material which it was selling to the contractors during the time this work was being carried on.

> "Plaintiffs in error knew of the existence of the suretyship, they knew that it was upon the faith of the bond executed by the defendant in error that they furnished the material; and they sold the same upon the understanding that they were to be paid for their material as the money was received by the contractors from the government."

In our case Mr. Hackett testified that with Mr. Hume he came to Vancouver and learned of the bond and that the sureties were responsible, and that, relying upon the faith of the bond, he sold material and that

he had an understanding with Rector that plaintiff was to be paid for the material as the money was received from the city.

> "Upon this state of facts, viz., that the contract between the plaintiff in error and Miner & Bro. was not one of credit, but that they were to be paid as the latter received money from the government on account of the work done, and that the money was paid by the government to Minor & Bro., who in turn would be paid to the plaintiffs in error, and they applied the same not to the debt due for material on the building, but for other outstanding debts previously existing between them; it would be manifectly unjust and unfair to allow plaintiffs in error thus to allow the money they had received for the work done on the building, and then require the defendant in error to make good to them a debt that would have been worthless but for the application thereto of money received from the government, which ought to have been applied to the payment of the debt for which the surety was bound."

Exactly the same situation prevails here. Here the plaintiff received money which came from this improvement and which should have been applied in satisfaction of the debt due for the material, and now to allow them to apply the money to other unsecured claims which

would be worthless but for this application and then to require the sureties to make good to them would be manifectly unjust and unfair.

> "This would be the result ordinarily in any case, and particularly so in the present one where the plaintiffs in error owed it to the defendant in error to exercise more than usual diligence to see that they were not innocently mulcted by reason of the suretyship."

This can be applied with equal force to the case now under consideration.

> "Defendant in error was actually led into this particular transaction by the act of the plaintiffs in error and surely no court will hear them contend that the surety executing the bond has not complied with its terms and conditions when they have actually received the money payable under the contract and applied it not in accordance with the terms of the contract, under which they sold their goods to the contractor, but applied it to another and different debt due themselves and which would have been worthless but for the misapplication of the payments thus made to them."

According to the terms of the contract as testified to by Mr. Hackett the rock was to be paid for when the

contractors received the money from the city; the money was received and paid to the plaintiff but was applied to another and different debt which would be worthless but for the misapplication of the payments made to plaintiff.

> "To allow them to apply the money received from the government to a pre-existing debt due them and leave the surety on the government contract in ignorance of the prevailing condition of affairs until after the contractors had failed and made an assignment would work a great hardship, if not result in an actual fraud on defendant in error, and cannot be countenanced, even if *innocently* done."

What the court here says cannot be countenanced is exactly what plaintiff is contending in this case; it is asking this court to permit it to apply the money received on account of the material which went into this improvement to another debt for which the sureties were not liable and which was not connected with this improvement, and then hold the sureties responsible for the material which went onto this street. The court in the case we have been quoting from says that this cannot be countenanced, even if *innocently* done.

The court further says:

> "In dealing with sureties the utmost good faith

must be observed, as in many cases, like the present, they are not able to know the exact conditions of the affairs of the parties for whom they have become surety."

So in our case, if the plaintiff is permitted to use the money which came from this improvement in payment of other debts due it from the contractors the sureties will be rendered liable, and if they had had any intimation of the arrangement which Mr. Hackett claims he had with Rector & Daly and of the course of procedure which they followed, the defendants could have protected themselves.

The above quotations are taken from the decision last cited and we have quoted extensively from this decision because it is directly in point and we think is conclusive of all of the questions involved in this case.

The district judge in passing upon the same question used this language:

"The law of suretyship forbids that there shall be such dealing between the debtor and creditor of which the surety is kept in ignorance as shall put the surety in a situation of peril."

That is exactly what the parties have done in this instance and was the inevitable result of the agreement which Hackett claims he had with Rector.

In support of the decision of the Supreme Court of Washington in *Crane Co. vs. Pacific Heat & Power Co.,* supra, and the case just cited in 89 Fed. 925, we would direct the court's attention to the case of *Bross vs. McNicholas,* 133 Pac. 783. This is a very recent decision by the Supreme Court of Oregon. The court here refers to the general proposition that a surety cannot direct the application of payments, but notes that this rule is applicable solely in those cases where the principal makes the payment from funds which are his own and free from any equity in favor of the surety to have the money applied in payment of the debt of which the surety is liable, but holds that,

> "where the specific money paid, or property delivered, to the creditor is the identical money or property for the payment and delivery of which the debtor and his surety obligated themselves by the contract of undertaking, the surety is not bound by an application of the money or property to some other debt for which the surety is not liable. In such cases the surety is equitably entitled to have the money paid or the property delivered applied to the payment of the debt or the liquidation of the contract for which he is liable,"

citing authorities.

We would also call the court's attention to *Ward vs. Womack,* 168 S. W. 433.

The lower court in passing on this question stated that the authorities were not uniform but that the weight of authority supports the position that we have taken, and we submit that not only is the weight of authority in harmony with our view but that all the equities of the respective parties would clearly justify and warrant a decision in favor of the sureties.

Counsel contend that we must be defeated because we have failed to prove that the plaintiff knew the source of the payments. Our answer to this contention is two-fold, first, we think that the evidence shows conclusively that the plaintiff had notice. We have already quoted sufficient of the abstract to show that the plaintiff knew of the contract which Rector & Daly had with the city, knew that they had given a bond as required by statute, and knew who the bondsmen were, and knew their financial responsibility; plaintiff knew that the payments were intended to be made upon the crushed rock because of the checks which plaintiff received which were marked for crushed rock, and under its agreement with Rector & Daly these payments were to be received on that account when Rector & Daly received their money, so when the checks were received for crushed rock it was evidence that payments were being made by the city for the crushed rock, and in addition to all this the rights of the plaintiff are measured and determined by the contract which Rector & Daly had with the city and all of its

terms and conditions, and plaintiff was bound to take notice that the payments were being received monthly based upon the engineer's estimates.

We think that the court will have no difficulty in reaching a conclusion after an examination of the record of this case, that plaintiff did have notice that payments were being made by the city monthly upon the engineer's estimates and that the contractors were receiving payments on that account and were making payments to plaintiff from money received from that source. This would be sufficient to answer counsels' contention, but we have another answer to counsels' contention and that is that where the sureties have an equity in a particular fund, as they had in this instance, and that particular fund was used to pay the particular liability that they had guaranteed would be paid, then the equities of the sureties control the application whether plaintiff had actual notice that the particular money which it applied had been received directly from the city.

None of the cases which are directly in point upon this question have held that notice is necessary. It is true that in the case of *Crane Co. vs Pac. Heat & Power Co.* it is alleged in the complaint that materialmen had notice, but the decision was not placed upon that ground and the court disposes of the case and announces the rule which we are contending for without any reference to the fact of notice.

In *First National Bank vs. National Surety Co.,* 130 Fed. 401, heretofore cited by us, the court says:

> "Neither does the fact that the officials receiving the payment were aware of the source of the money appear to have been regarded as material."

In the case referred to reported in 89 Fed. 925, heretofore cited by us, no question of notice was considered, but the broad principle of the rights of the sureties in this fund was the controlling factor in the court's decision, but the court in this case expressly held that the materialman would not be permitted to make such an application of payments even though innocently done. The question which the court had in mind was the very thing which counsel are contending for here. Counsel say that unless they had notice of the source of the fund that they were at liberty to apply these payments in any manner that they might see fit, although it would operate as an actual fraud upon the sureties, but the court here says that such conduct cannot be countenanced even though innocently done. This decision meet counsel squarely on this point and is sufficient to dispose of their contention so far as this phase of the case is concerned.

Counsels' argument upon this question applies to general payments, but they overlook the position which the courts have taken with reference to the rights of the sureties under these statutory bonds and do not properly note the exception which should be applied.

The lower court stated in its decision that there was not sufficient in the record to authorize a finding of notice, but there was sufficient to constitute reasonable grounds for belief upon the part of plaintiff that such payments were from that source and was enough to put him upon inquiry as to the source from which they were derived.

Where the sureties' equities in a fund were of such an order as this court and other courts have determined in cases of this kind it is sufficient notice to plaintiff that it had reasonable grounds for belief and was sufficent to put it upon inquiry because if it had reasonable grounds for belief that this money was coming from the city, that the payment which it received was from funds which the contractors had received on account of this improvement, that was sufficient to put it upon inquiry, and knowing of the rights and equities of the sureties it was its duty to pursue that inquiry to prevent fraud upon the sureties and that alone would be sufficient notice when we consider the relative positions and rights of these parties. But here instead of pursuing inquiry of which it had reasonable grounds for belief the plaintiff refused to make any further inquiry or to accept any payments or to take any steps which could possibly put it in possession of information because it was unwilling to receive such information. Its conduct must convince the court that it did not desire such information, for even

though it had received it it was determined that the sand and gravel account should be paid first.

We contend that there is no sufficient evidence in the record to show that plaintiff ever made any application of the payments, and not having made any until after this trial was commenced that it is the duty of the court to make such application according to the rules of justice and equity, and such rules would clearly relieve these sureties under the record in this case.

Although plaintiff was relying upon its books to show its account between it and the contractors and the application which it had made of the payments, it produced no books in court so that an examination of the books might disclose when and in what manner the applications had been made. The testimony of the witnesses as to how the books showed the money had been applied was clearly incompetent because the books were the best evidence.

The statements furnished to the sureties disagreed, no two of them were alike, the bookkeeper admitted that he had made mistakes in the application of the first check which was received; the statements furnished on November 1st showed that the check for $1000.00 was applied on the crushed rock account, and the $662.50 on the sand and gravel account, although at the time of the trial and in the bill of particulars furnished defendants

were given credit for $662.50 on the crushed rock account. In the statement rendered on December 30th, being plaintiff's Exhibit No. 16, plaintiff was asking a balance of $6693.68, and in the claim which the plaintiff presented to the city on account of the crushed rock furnished on this improvement plaintiff was claiming $6693.68.

These and a number of other circumstances, together with the entire absence of the books render it extremely doubtful that the plaintiff made any applications of the payments.

The court did not make any findings upon this question, but did state that it was sufficient to render doubtful the question of any such application, and we think that in view of the unsatifactory condition of the record on this question and in view of the fact that plaintiff did not produce its books and offered no competent evidence upon that subject, that the plaintiff has failed to establish that it made the application of the payments it received from the contractors and that it was for the court to make the application, and the lower court has in effect made it, and its decision was in favor of the sureties.

Counsel contend in their brief that the evidence does not show that the notes which were given by the contractors to the Vancouver Trust & Savings Bank at the time the checks in question were paid, were paid from funds

received from the city. It is not material whether the notes were paid at all, or not. At the time the checks were presented Rector & Daly had no funds in the bank; in order to meet the checks the contractors gave notes to the bank in accordance with their agreement with the bank that the bank would advance money based upon the estimates from this improvement and the notes were given with the distinct understanding and agreement that they were on account of this improvement and it simply constituted an advancement by the bank to the contractors, but the evidence shows that the bank received something over $22,000.00 from the city in money and bonds which it cashed, on account of this improvement. These notes were given as an advancement against this fund and it is not material what became of the notes so long as they were based upon this fund, made against the fund, and were simply an advancement until the money was received from the city.

In conclusion we desire to call the court's attention to the fact that it has been uniformly held by the Supreme Court of the United States in a long line of decisions that

> "The contract of a surety is to be construed strictly and is not to be extended beyond the fair scope of its terms."

This quotation is taken from the Enc. of U. S. Su-

preme Court Reports, vol. 9, page 718, and a long line of authorities cited in support of the rule.

It is also to be remembered in this case that these were accommodation sureties so far as anything in the record appears. The rights of these defendants are not to be measured by the same rule that the court measures the rights of a surety company that undertakes to guarantee the performance of a contract for hire, but they fall within the rule noted above and are entitled to the consideration which has always been applied to ordinary sureties.

We respectfully submit that the judgment of the district court was in harmony with the weight of authority in cases of this character and that it is in line with what the record will disclose in this case to be right and is but the application of common justice.

Respectfully submitted,

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